State responses to The Tax Cuts and Jobs Act

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Overview

The Tax Cuts and Jobs Act (TCJA) signed into law on Dec. 22, 2017, was a sweeping legislative jolt to almost every aspect of individual and business taxes at a scale not seen since the Tax Reform Act of 1986. The TCJA provided reduced rates for individuals, established a lower flat tax rate for corporations, limited certain deductions and changed the foreign tax landscape as we know it, among a myriad of other important provisions. The sweeping changes sent states scrambling to determine its impact on their tax base and forced states to re-evaluate their conformity to the Internal Revenue Code (IRC). This insight discusses some of these effects and the varying state responses to federal tax reform.

Conformity in general

Before we discuss the implications the TCJA had at the state level, it is important to know the various ways states conform to the federal tax code, as detailed below:

- **Rolling conformity** – States automatically adopt the current IRC as it is updated and revised, unless the state has preexisting laws that decouple from specific code provisions.
- **Annual conformity** – States adopt the IRC as of a certain date (e.g., Dec. 31, 2017) and generally do so affirmatively on an annual basis.
- **Fixed conformity** – States affirmatively adopt the IRC as of a specific date (e.g., Dec. 31, 2017) during their 2018 legislative sessions.
- **Other conformity** – States continue to follow or decouple from specific code sections as they have historically done.

Accelerated depreciation

Two major changes to federal depreciation provisions were included in the TCJA. First, the Act permits 100% bonus depreciation on qualified new and used tangible property under section 168(k). Second, the section 179 accelerated depreciation limit was increased from $500,000 to $1 million with the related investment limits also increased.

The majority of states decouple from bonus depreciation under section 168(k), but over half adopted the new $1 million section 179 limit with other states, allowing at least some amount of accelerated depreciation. States that historically decoupled from bonus depreciation remained relatively unchanged. One observation, however, is that several states who previously conformed to sections 168(k) and 179, and whose tax revenues were negatively impacted by full expensing, decoupled or limited the provisions in some way. This increase in federal-state depreciation decoupling, and asset cost basis differences that were created as a result, led to additional complexities and compliance burdens.

State responses to the $10,000 state tax limit

Arguably the provision in the TCJA impacting the most taxpayers is the $10,000 limit ($5,000 if married filing separately) on state and local taxes allowed as a deduction on Schedule A.

One response to this limit was high-tax states subjecting pass-through entities (PTEs) to an entity-level income tax. This tax is deductible on the PTE’s tax return, effectively providing for a full state deduction of income taxes paid. To avoid double taxation, pass-through entity owners receive an offsetting credit for taxes paid by the pass-through entity on their personal returns. Notable states to implement pass-through entity taxes as a workaround to the SALT cap are Connecticut, Wisconsin, and more recently, Oklahoma. It is still unclear how these strategies will be viewed by the IRS. To further complicate things, Wisconsin's entity-level tax is voluntary where a taxpayer can elect to be taxed at the entity-level or not. This raises additional questions as to whether the IRS will respect the arrangement and allow an ordinary business deduction for these state taxes paid voluntarily at the entity level.

One of the more interesting responses to the $10,000 limitation is the charitable contribution approach, where states offer tax credits for all or a percentage of contributions made to state-operated charitable funds. For example, New York allows taxpayers to claim a state tax credit equal to 85% of the donation to certain state-run healthcare and education funds. Final Treasury regulations issued on June 11, 2019 effectively eliminate this workaround by requiring taxpayers to reduce their federal charitable contributions by any state tax credits received. It is noted however that no adjustment to charitable contributions is necessary if the state tax credit received is less than 15% of the fair market value of the contribution.

Certainly not a new strategy to reducing state tax liabilities is moving from high-tax states like New York to low-income or no-income tax states such as Florida, with the new $10,000 limit on state taxes creating more of an incentive to do so. While this is a viable option to reduce state tax liabilities, it should be noted that high-tax states have been aggressive in auditing taxpayers claiming residency in other states. The onus is on the taxpayer to prove they have established residency elsewhere, and factors beyond just the number of days spent in a state will be taken into account during examination. These items may include facts such as where your social or health clubs are located, cell phone records, where your charitable contributions are made, and your reason for changing domiciles.

Section 199A

With the qualified business income deduction under section 199A estimated to cost the federal government approximately $414.5 billion over the next 10 years, it makes sense that states would decouple from this provision if their revenue loss is significant. It is noted however that the vast majority of states begin their individual income tax calculations with federal adjusted gross income (AGI), meaning these states are not affected by this federal deduction. Currently only three states allow this deduction: Colorado, Idaho and North Dakota, as they start with federal taxable income, conform to the IRC on a rolling basis and have not explicitly decoupled from the deduction.

Other provisions

The TCJA expanded the definition of qualified expenses under section 529 college savings plans to now include certain K-12 expenses. Approximately 32 states and the District of Columbia permit some form of deduction for contributions made to a section 529 plan. This created interesting and varying levels of conformity depending on how a state defines qualified expenses (i.e., if it's tied to the federal definition), as well as the impact on their tax base.

A few other TCJA provisions affecting state taxes include the business interest expense limitation under section 163(j), and the changes to the federal net operating loss (NOL) rules. Decoupling from section 163(j) creates timing differences for disallowed interest carried forward indefinitely for federal purposes but expensed at the state level. The vast majority of states also decouple from federal NOL rules by providing their own treatment. Additional compliance burdens are created since pre- and post-TCJA NOLs must be tracked and applied separately. These provisions are great examples of the additional complexities, record-keeping requirements and state tax compliance burdens caused by tax reform.

Conclusion

Besides materially changing the federal tax landscape, the TCJA sent shockwaves reverberating through all areas of state tax. States were forced to determine the impact each provision had on their tax base and align their conformity with the new IRC based on their specific budgetary goals. This creates additional record-keeping requirements and complexities when states decoupled from new provisions or provisions they conformed to in the past. The new compliance landscape and varying rules between federal and state tax law makes it even more imperative to speak with a tax professional to determine the optimal strategy for you or your business.